Fiskālās disciplīnas padome

Monitoring report Nr. 18

Period 01.05.2022-27.06.2022

SUMMARY

1. Russia's aggression in Ukraine and subsequent sanctions have now become the biggest threat to the economic development of Latvia and the whole world. The war will slow down the global economic growth and increase inflation. Earlier this year, as countries began to recover convincingly from the pandemic crisis, rather optimistic growth forecasts were made, which had to be substantially revised a few months later. In April, the IMF cut its January global growth forecast by 0.8 percentage to 3.6%[1]. The European Commission also cut its EU and eurozone GDP forecast in April. Real GDP growth is currently projected at 2.7% in both the EU and the euro area in 2022, compared with 4.0% in the winter. Inflation forecasts, on the other hand, are the highest in the history of the EU. The EU inflation is projected at 6.8% in 2022, compared to 3.9% projected in the winter, and 6.1% in the euro area, adjusting the 3.5% winter forecast.[2]
2. The IMF forecasts that the Russian economy will shrink by 8.5% this year and the Ukrainian economy - by 35%. The war could lead to an increase in hunger in many developing countries and an increase in asylum seekers in the EU. The Energy and Clean Air Research Center in Finland estimates that Russia generates nearly $ 1 billion a day from gas and oil exports, while Russia's war costs about $ 876 million a day, so energy exports cover the war in full and with reserve. This points to the possibility that the war could last long with corresponding economic and fiscal consequences.
3. A period of restrictive monetary policy has begun in the developed world, which includes both raising central bank interest rates and reducing central bank balance sheets. Although the US is a leader in this area, the ECB has also signaled about the rise in interest rates and the subsequent discontinuation of asset purchases in this year July. Such a policy is needed to reduce inflation, which is a precondition for sustainable and balanced economic growth. However, rising interest rates are likely to dampen economic growth and increase the cost of servicing sovereign debt, especially in high-debt countries. For Latvia, however, these risks are relatively small.
4. In the context of high and rising inflation, the actions of the EU's monetary and fiscal policymakers, namely the European Central Bank and the European Commission, include restrictive monetary policy and stimulative fiscal policy. The EC has announced that the general escape clause of the Stability and Growth Pact will remain in force in 2023, giving eurozone governments more flexibility in drawing up next year's budget. This is a unique situation where monetary and fiscal policy instruments are contradictory, due to the vital need for state support, especially for the poor, in the context of the 'gas' war and the sharp rise in prices.
5. In the first quarter of 2022, Latvia achieved the highest GDP growth in the Baltics of 6.4%. In Lithuania, GDP grew by 4.6% in the first quarter, and in Estonia by 4.3%. The outcome of the first quarter will have a positive impact on annual GDP growth, which could help sustain growth in the event of a recession. At the beginning of June, the Bank of Latvia raised its GDP forecast from 1.8% to 2.9%, in response to the growth results of the first quarter. However, despite a convincing economic recovery, the risks of a

[1] World Economic Outlook, April 2022: War Sets Back The Global Recovery (imf.org)
[2] Spring 2022 Economic Forecast: Russian invasion tests EU economic resilience | European Commission (europa.eu)

recession in the second half of 2022 and/or 2023 in Latvia are very real. In general, since the beginning of the war in Ukraine, Latvia's GDP forecast for this year has been reduced by almost half and fluctuates around 2%. In April, the European Commission also revised Latvia's GDP forecast, reducing it from 4.4% in winter forecast to 2%.

6. Economic sentiment indicators point to an expected slowdown in economic growth in the coming quarters, especially in construction and industrial sectors. There is particular concern about the overall economic situation and household consumption over the next 12 months, which is below the long-term average according to several indicators. At the moment, the only optimistic sector is retail, but this optimism decline may fall as consumer income falls.

7. The war in Ukraine and sanctions against Russia significantly changed the volume of Latvia's exports to Russia, Belarus and Ukraine. In the first quarter of 2021, the total share of exports to these countries was 10%, but in the first quarter of this year it dropped to 7%. Exports started to decline in the first quarter and fell by 7%, while in April it declined by 33%. The opposite is the case with imports from Russia, Belarus and Ukraine, which rose by a total of 77% in the first quarter (especially from Russia by 113%) and also showed an increase of 14% in April.

8. Latvia's inflation forecasts were adjusted significantly. In June, the Bank of Latvia raised its inflation forecast for 2022 from 9.5% to 14.8%. In a context where inflation is mainly external and mainly on the supply side, the scope for reducing price rises is severely limited. Support from the state budget will partially balance the consequences of rising energy prices but will not affect the cause of inflation.

9. Latvia's inflation rate is one of the highest in the EU, reaching 16.9% in May. With rising energy prices and the start of the heating season, this situation could fall into two difficult-to-control scenarios. As household costs rise, the pressure from employees to raise wages will rise as well. If it happens, the demand will pick up, which in turn will increase inflation which could lead to an inflationary spiral. On the other hand, if the income of the population lags behind inflation for a long time and the demand decreases, it may lead to a decrease in real income, which would slow down economic growth. Wage growth is currently lagging behind inflation. In the first quarter, wages and salaries rose by 6.9% and inflation by 9.2%.

10. In a context of high inflation, the government should consider remuneration policies in public sector. On the one hand, wages should not be excessive in order not to stimulate inflation, on the other hand, they should be competitive with the private sector so as not to reduce public sector's capacity.

11. On May 25 this year, the Fiscal Discipline Council held a high-level expert discussion on "The Fiscal Impact of High Prices: Scenarios and Challenges". The discussion focused on the threat of inflation, fiscal risks and possible solutions in the field of energy. In the context of rising inflation, government fiscal policy needs to remain accommodative, while maintaining some restraint to prevent uncontrolled increases in budget expenditure, is one of the conclusions of the discussion. A summary of the discussion is available on the FDC website[3].

12. During the seminar it was also concluded that the normalization of energy prices will play a crucial role in the normalization of inflation both globally and in Latvia. The coming heating season will be problematic for both businesses and households. At the beginning of the year, household energy expenditure was reduced through direct government

[3] Available: https://www.fdp.gov.lv/lv/media/3701/download, viewed 27/06/22

discretionary support measures. However, as early as this autumn, energy consumption by consumers (households and businesses) is likely to be much higher. Fiscal policy will need to be designed on the assumption that high and potentially volatile energy prices will persist over the longer term. At the same time, the priority of the Latvian economy will be to increase local energy production and diversify energy sources, which will require substantial investment. Decisive action to ensure the supply of natural gas at an affordable price will be crucial in maintaining the competitiveness of the Latvian economy and promoting the well-being of the population. The optimal solution would be a long-term gas supply agreement between the Baltic States and Finland. The construction of a liquefied natural gas (LNG) terminal in Latvia is also an option to consider. The challenges of natural gas logistics are currently related to the fact that Latvia imports LNG through the port of Klaipeda, but due to the growing Polish consumption, this supply route is not sufficient for Latvia, as Lithuania and Poland take a large part of Klaipeda's capacity. If the gas terminal capacity is not ensured this year and unfavorable conditions coincide, preconditions for a gas deficit scenario may arise in Latvia. The main short-term goal is to ensure an adequate energy supply, and as Russia increasingly uses energy as a weapon, contingency plans must be in place in the event of an energy supply disruption.

13. Latvia has prepared and submitted to the European Commission a Stability Program for 2022-2025[4], which projects GDP growth of 2.1%, inflation of 8.5% and a general government balance of - 6.5% of GDP in 2022. However, the situation could be much worse, as economic development is threatened by a number of risks. The main risk factors include geopolitical threats, soaring energy prices, energy shortages, rising production costs and supply chain disruptions.

14. In a situation where the EC has extended the period of flexibility of fiscal policy, Latvia's support policy must be commensurate with the support policies of other EU Member States in order not to worsen the competitiveness of Latvian enterprises. However, it should be noted that already in 2021, the deficit level in Latvia (7.3% of GDP) was one of the highest in the EU. The highest budget deficit in the EU is planned for this year as well (6.5% of GDP), especially considering that the calculations do not yet consider the impact of the compensations in the autumn for the increase in energy prices on the general government budget balance. In its recommendations to Latvia, the European Commission has indicated that Latvia should not increase its budget base expenditure above the growth of its economic potential. In the medium term, fiscal expenditure consolidation may be needed, which could slow the growth.

15. Despite high deficit ratios, Latvia has managed to maintain a relatively low level of government debt and a good reputation in international financial markets. The projected debt level for this year is 45.7% of GDP. As nominal GDP growth is high (+10.9% in the first quarter of this year) due to increased inflation, it can keep the debt-to-GDP ratio at an acceptable level. Credit rating agencies maintain Latvia's credit rating at a consistently high level (S&P Global A +, Fitch Ratings A-).

16. Due to the rising inflation, the positive trend in tax collection continues. In April and May 2022, compared to the respective months of 2021, the amount of taxes collected increased by 2% and 18% respectively. Expenditure in the basic budget decreased by 11% in April but increased by 14% in May. Social budget expenditure increased in both

4 https://www.fm.gov.lv/lv/media/11080/download

April (10%) and May (14%). In total, the consolidated budget balance at the end of June this year is more than 200 million euros better than a year ago.

17. The government has approved a report by the Ministry of Welfare entitled "Support measures to mitigate the impact of rising energy prices and headline inflation on vulnerable groups", which provides that the support is partly targeted to support vulnerable groups, and partly aimed at all households. The Council welcomes the government's move to reduce the impact of rising energy prices, but notes that the fiscal impact of the support measures could significantly exceed the projected budgetary impact of € 350 million due to unpredictable fluctuations in energy prices. The Fiscal Discipline Council calls on the government to set up an integrated information database, which would increase the possibilities for providing even more targeted support to groups with different income levels.